

No. 7735

In the United States Circuit Court of
Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

THE PROCTOR SHOP, INC., RESPONDENT

ON PETITION FOR REVIEW OF DECISION OF THE UNITED
STATES BOARD OF TAX APPEALS

BRIEF FOR THE PETITIONER

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OPINION BELOW

The only previous opinion in this case is that of the United States Board of Tax Appeals (R. 17-21) which is reported in 30 B. T. A. 721.

JURISDICTION

This case involves income taxes for the fiscal year ended January 31, 1930, in the amount of \$681.74. This appeal was taken from the decision of the United States Board of Tax Appeals entered July 11, 1934 (R. 22). The case was brought to this Court by petition for review filed October 5,

1934 (R. 22-27), pursuant to Sections 1001-1003 of the Revenue Act of 1926, c. 27, 44 Stat. 9, as amended by Section 1101 of the Revenue Act of 1932, c. 209, 47 Stat. 169.

QUESTION PRESENTED

Whether amounts paid by the taxpayer corporation to the holder of "debenture preference stock" were deductible as interest or whether such amounts were in the nature of a dividend on preferred stock.

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest*.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title.

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

ART. 141. *Interest*.— * * * So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income. * * *

STATEMENT

The facts embodied in the findings of fact by the Board (R. 11-17) may be briefly summarized as follows:

The taxpayer, an Oregon corporation, was organized in 1927 and upon organization acquired the assets of the business known as "Proctor's, Incorporated", which was engaged in selling women's ready-to-wear apparel. The business was continued along the same lines (R. 11).

In order to finance the new corporation, Aaron Holtz contributed the necessary funds prior to its organization and received in exchange therefor "debenture preference stock." As was contemplated at the time, Merriman H. Holtz, son of Aaron Holtz, became president of the taxpayer corporation (R. 11-12).

According to the articles of incorporation filed in October 1927 (R. 13), and in its annual report (R. 15) to the State Corporation Department for the year ended January 31, 1928, the taxpayer's capital stock was \$100,000 divided into 990 shares of "debenture preference stock" and 10 shares of common stock, each classification having a par value of \$100 (R. 13). All of the 990 shares of "debenture preference stock" were issued to Aaron Holtz (R. 15).

Although Aaron Holtz had been willing to lend the necessary funds to the contemplated organization but was not willing to accept stock because he de-

sired to be assured that his advances would be repaid and also wanted a definite income from the funds, it was nevertheless deemed inadvisable to issue bonds to cover the loans as that would affect the credit of the corporation. (R. 11.) Over objection and exception, a letter was admitted in evidence from the attorney for the taxpayer to Meriman H. Holtz, stating that the debenture preference stock certificates did not give their holder precedence over banks and other creditors but would entitle him to precedence over stockholders. His conclusion was that the certificates would entitle the holder to payment of interest whether profits were earned or not and that the failure to pay on the part of the corporation would place the holder in position to sue for the principal amount (R. 12-13).

The certificates for the debenture preference stock recited on their face certain provisions quoted from the articles of incorporation (R. 13-15). Among these was a statement of the capital stock of the corporation of \$100,000, divided into the same classifications and amounts set forth in the articles of incorporation. They also recited that the stock was entitled to cumulative interest at the rate of 6% per annum before any dividends were to be paid on the common stock and in the event of dissolution of the corporation or distribution of its assets the debenture preference stock was first to be paid at par. Provision was also made against voting power and for the retirement of the debenture

ture preference stock at par but the failure for a period of two years to pay any quarterly interest was to render the corporation in default and to entitle the holders to declare the principal amount due and to institute action against the corporation for the par value, plus accumulated interest. The rights of the holders were specifically made inferior to the claims of general creditors and superior to the holders of any other class of stock (R. 13-15).

The amounts involved in this case, representing six percent per annum on the debenture preference stock held by Aaron Holtz, were paid by the taxpayer and were claimed as interest deduction by the taxpayer for the taxable year in question.

From the action of the Commissioner in denying the taxpayer's right to deduct payments made on its debenture preference stock, the taxpayer appealed to the Board of Tax Appeals which upheld the taxpayer's contention.

SPECIFICATION OF ERRORS TO BE URGED

The specification of errors is set forth in detail on pages 25 and 26 of the record and may be summarized as follows:

The Board of Tax Appeals erred: (1) in holding that the amounts paid by the taxpayer corporation constituted interest on indebtedness; (2) in holding that the debenture preference stock constituted indebtedness of the taxpayer corporation; (3) in

failing to hold that the amounts paid by the taxpayer corporation constituted payment of a dividend; (4) in failing to hold that the debenture preference stock was in fact and in law preferred stock; (5) in holding that there was a deficiency in tax for the fiscal year ended January 31, 1930, in the amount of \$23.39 and (6) in failing to hold that there was a deficiency in tax for the fiscal year ended January 31, 1930, in the amount of \$681.74.

SUMMARY OF ARGUMENT

The only question involved in this case is whether certain payments made on so-called debenture preference stock were in the nature of interest on indebtedness which is an authorized deduction in computing net income, or whether in reality they constituted dividends on stock which are not deductible.

The actual character of the certificates as determined by an examination of all the elements gives them the legal effect of stock rather than bonds or other forms of indebtedness. The designation of the payments as "interest" rather than "dividends" is not controlling.

The provisions of the taxpayer's articles of incorporation and its corporate report showing the capital structure as including debenture preference stock, as well as the reasons for its issuance in that form, reveal an intention to issue stock, especially in view of the ratio of 99 to 1 of common stock. The other provisions against voting power,

for retirement of the stock, payment of interest, and the right of suit upon default do not endow the certificates with the nature of indebtedness, especially where general creditors are specifically preferred and the only preference is one peculiar to all preferred stock.

The admitted purpose of issuing debenture preference stock and not bonds was to protect the credit of the corporation which otherwise would have had a paid-in capital of only \$1,000 instead of \$100,000. In the form as issued the credit was not impaired because the corporation surrendered no security and the stockholders' rank was inferior to the creditors'.

The certificates in this case represent capital stock and not ordinary indebtedness since on their face they provide that the holders are not entitled to participate in the corporate assets, even to the extent of their par value, until ordinary creditors are satisfied.

ARGUMENT

The nature of the certificates issued and the manner in which they were authorized show that they were certificates of preferred stock and not evidences of ordinary indebtedness

Section 23 (b) of the Revenue Act of 1928, *supra*, provides that in computing net income there may be deducted from gross income all interest paid on indebtedness. It is provided, however, by Article 141 of Treasury Regulations 74, Promulgated

under Section 62 of the Revenue Act of 1928, that "So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income."¹ The sole question in the instant case is whether certain certificates

¹ This regulation has been in effect under all the Revenue Acts, beginning with that of 1918 and including that of 1934 (Revenue Act of 1918, c. 18, 40 Stat. 1057, Sec. 234 (a) (2); Regulations 45, Art. 564; Revenue Act of 1921, c. 136, 42 Stat. 227, Sec. 234 (a) (2); Regulations 62, Art. 564; Revenue Act of 1924, c. 234, 43 Stat. 253, Sec. 234 (a) (2); Regulations 65, Art. 564; Revenue Act of 1926, c. 27, 44 Stat. 9, Sec. 234 (a) (2); Regulations 69, Art. 564; Revenue Act of 1928, c. 852, 45 Stat. 791, Sec. 23 (b); Regulations 74, Art. 141; Revenue Act of 1932, c. 209, 47 Stat. 169, Sec. 23 (b); Regulations 77, Art. 141; Revenue Act of 1934, c. 277, 48 Stat. 680, Sec. 23 (b); Regulations 86, Art. 23 (b)), in all of which Acts the same or similar provisions to that here involved appeared. In the light of this frequent reenactment of the provision without change there can be at this late date no doubt that the regulation above quoted has the force and effect of law. *Heiner v. Colonial Trust Co.*, 275 U. S. 232; *Brewster v. Gage*, 280 U. S. 327, 337; *Elko Lamoille Power Co. v. Commissioner*, 50 F. (2d) 595 (C. C. A. 9th). The case of *Elko Lamoille Power Co. v. Commissioner*, *supra*, not only approves of the distinction made in the regulation referred to but recognizes the well-settled distinction between preferred stockholders and creditors. There this Court said, "A preferred stockholder is a mode by which a corporation obtains funds for its enterprise without borrowing money or contracting a debt, the stockholder being preferred as to principal and interest, but having no voice in the management. *State, ex rel. Thompson v. C. & C. R. R. Co.*, 16 So. Car. 524. It differs only from other stocks in that it is given preference and has no voting right. A preferred stockholder is not a creditor of the company. *Scott v. Balto. & Ohio R. Co.*, 93 Md. 475; *Lockhart v. Van Alstyne*, 31 Mich. 76."

issued by the taxpayer are evidences of an ordinary corporate indebtedness entitling it to the interest deduction under Section 23 (b), *supra*, or whether such certificates are preferred stock with respect to which no deduction may be had for dividends paid thereon by virtue of Article 141, *supra*. The Board of Tax Appeals held that the payments in question represented interest and were therefore deductible. We contest the correctness of the Board's conclusion. That these were certificates of preferred stock and not evidences of corporate indebtedness is gathered first from the circumstances surrounding their issue. It was deemed inadvisable to issue bonds (R. 11). The certificates were issued pursuant to a charter provision which described the capital stock of the corporation and included therein the 990 shares of debenture preference stock (R. 13). This fact is indicative of an intent of the parties to issue stock and not borrow money. Indeed, at the time the holder of the certificates agreed to subscribe, the corporation was not yet in existence so as to negotiate a loan. (R. 11.) It is to be noted that the creation of indebtedness needs no charter provision to give it authorization. *Mining Co. v. Anglo-Californian Bank*, 104 U. S. 192; *Gorrell v. Home Life Ins. Co.*, 63 Fed. 371 (C. C. A. 7th).

In order to determine the fundamental character of the certificates it is necessary to view the terms in their entirety and not to segregate one clause in order to reach a conclusion. *In re Culbertson's*,

54 F. (2d) 753 (C. C. A. 9th). Although it is not contended that the designation of the certificates as stock is wholly controlling, it is an important fact to be considered because the real character of the certificates is attested by the language of the entire instrument. Cf. *Armstrong v. Union Trust & Savings Bank*, 248 Fed. 268 (C. C. A. 9th). In *Commissioner v. O. P. P. Holding Corp.*, 76 F. (2d) 11 (C. C. A. 2d), one of the most impelling reasons for the conclusion reached was the designation of the instrument. It was stated (p. 13):

The petitioner urges that the name given to an instrument is not controlling, but that its inherent characteristics will determine its true nature and legal effect. This may be conceded, but it does not follow that the name by which the certificates are designated is to be completely ignored. Stocks and bonds both evidence a contract between their holders and the issuing corporation, and, in construing this contract, the language used in reducing it to writing will be indicative of the intention of the parties. See *Spencer v. Smith*, 201 F. 647, 651 (C. C. A. 8).

It is certainly not conclusive that the taxpayer in its articles of incorporation and its stock certificates designated the payments to be made by it as "interest" rather than "dividends." *Smith v. Southern Foundry Co.*, 166 Ky. 208, 179 S. W. 205; *Aluminum Castings Co. v. Routzahn*, 282 U. S. 92, 99.

The certificates issued by the taxpayer bear on their faces all the indicia of preferred stock (R. 15). In attempting to avoid the impairment of its credit by not issuing bonds (R. 11) the taxpayer was willing to bestow the guise of stock upon the certificates issued by so designating it in its articles of incorporation and in its first annual report to the State Corporation Department (R. 13-15). It now seeks to avoid the consequences from the standpoint of taxation by contending that what it actually issued were not really certificates of stock but certificates of indebtedness. In *People, ex rel. Cohn & Co. v. Miller*, 180 N. Y. 16, 72 N. E. 525, in considering certificates of a similar nature, it was said (pp. 22, 23):

If a corporation may organize with a capital of \$150,000, as alleged in its annual report to the comptroller and on the face of its certificate of preferred stock, leading the general public to believe that the total amount of its certificates represents capital contributed for the conduct of its business, when in fact two-thirds of the amount, instead of representing what its name indicates, is in fact a debt pure and simple, there is no safety in dealing with corporations.

* * * * *

The certificate of preferred stock in the case at bar states in its heading that the capital stock of the relator is \$150,000. Nevertheless, we find in the body of the certificate, and in the terms and conditions endorsed

reversing 12 B. T. A. 772, where the amounts could be withdrawn at any time, although even in that case amounts already paid in were regarded as subject to the hazards of the business and dividends paid thereon were not allowable deductions as interest.

In practically all of the cases where a similar question has arisen the courts have given a great deal of weight to the position of the holder with reference to general creditors of the corporation. *Kentucky River Coal Corp. v. Lucas*, 51 F. (2d) 586 (W. D. Ky.); *Spencer v. Smith*, 201 Fed. 647 (C. C. A. 8th); *In re Fechheimer-Fishel Co.*, 212 Fed. 357 (C. C. A. 2d); *Fidelity Savings & Loan Ass'n v. Burnet*, 65 F. (2d) 477 (App. D. C.). In the case at hand the holder of the debenture preference stock was specifically subordinate to general creditors. One of the characteristics of capital stock "is, that no part of the property of a corporation shall go to reimburse the principal of capital stock until all the debts of the corporation have been paid." *Warren v. King*, 108 U. S. 389, 396. The consideration surrendered to a corporation in exchange for stock represents the capital on which a corporation is authorized to do business and constitutes one of the assets to which all creditors may look for the payment of their demands. *Armstrong v. Union Trust & Savings Bank*, *supra*. It is, therefore, most important to the consideration of this case to look upon the relation which the holder of the debenture preference stock bears to general

creditors. He enjoys no higher standing than does the preferred stockholder in other corporations and his position as regards general creditors leaves him without any of the attributes usually existent in a debtor-creditor relationship. With the other stockholders he is merely a co-adventurer in the business.

We submit that this case comes within the rule of *Armstrong v. Union Trust & Savings Bank, supra*; *Elko Lamoille Power Co. v. Commissioner, supra*, and *In re Culbertson's, supra*, all of which were decided by this Court.

It is contended that an examination of all of the provisions of the instruments, the circumstances attending the incorporation of the taxpayer and the issuance of the certificates will lead to the conclusion that the amounts paid were in reality dividends on preferred stock.

CONCLUSION

The decision of the Board of Tax Appeals should be reversed.

Respectfully submitted,

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SEPTEMBER 1935.

